

## CHAPTER 4: FINANCIAL MANAGEMENT

### 4.1 INTRODUCTION

Successful projects require sound financial management procedures to track funds, prepare realistic budgets, manage project funds effectively, and report financial progress. This chapter covers the borrower's financial management responsibilities and provides guidance to Loan Servicers on how to monitor a borrower's financial management performance.

The chapter is divided into five sections. Section 1 describes program requirements and Agency monitoring responsibilities for the project accounting system. Section 2 discusses the contribution, use, and monitoring of Initial Operating Capital. Section 3 outlines the requirements for and monitoring of reserve accounts. Section 4 explains project budget requirements and the budget approval process. Section 5 describes project reporting and financial examinations and Agency review of these reports.

### SECTION 1: PROJECT ACCOUNTING SYSTEM

#### 4.2 OVERVIEW OF ACCOUNTING SYSTEM REQUIREMENTS [7 CFR 3560.302]

Borrowers must establish accounting systems that support safe and sound project financial management. The accounting system must allow borrowers to track the use of funds, report accurate operational results to the Agency, and otherwise comply with the terms of their loan agreement. The following requirements apply to the borrower's accounting system:

- **Agency approval.** The accounting system must be approved by the Agency as part of the management plan (as discussed in Chapter 3). The borrower must notify the Agency of any changes in the method or system of accounting through a revision to the project management plan.
- **Method of accounting.** The borrower may use a cash, accrual, or modified accrual method of accounting.
- **Record keeping.** Borrowers must retain all financial records and supporting material for three years after the issuance of annual financial reports and financial statements. These records must be maintained in a manner that can be audited by the Agency or a third party. The Agency may request that these materials be made available if needed to examine the project's finances.
- **Account requirements.** The following general requirements apply to the borrowers' accounts.
  - ◇ Accounts must be in domestic institutions.

- ◇ Accounts must be insured by an agency of the Federal Government, backed by collateral proved by the bank or held in securities meeting the requirements of 7 CFR Part 3560, subpart G.
- ◇ Borrowers must maintain at least one demand deposit or checking account (so that funds are always readily available to pay necessary operating expenses).
- **Use of funds.** Funds must be held in trust by the borrower until used and serve as security for the Agency grant or loan (except for funds in the security deposit/membership fee or patron capital accounts.)
  - ◇ In no case may project funds be pledged as collateral for nonproject debts.
  - ◇ Funds must be used only for authorized purposes as described in 7 CFR Part 3560, subpart G and the project loan agreement or resolution.
- **Separate accountability.** The accounting system must establish separate accountability for different projects. In other words, the borrower may combine funds from different projects in the same bank account as long as the accounting system segregates and tracks each project's funds separately.
  - ◇ The borrower must provide to the Agency a certification from a Certified Public Accountant stating that the system will segregate accounts for separate projects.
  - ◇ The management plan must document how revenue and expenses that are not clearly associated with a particular project are prorated across projects. (For example, the plan must document how costs for a computer system that serves several projects are allocated across the projects.) The accounting system must track these prorated costs.

#### 4.3 OVERVIEW OF ACCOUNTS

The borrowers must establish and maintain the accounts required by their loan agreement or resolution. At a minimum, these include the accounts listed below.

- General Operating Account;
- Tax and Insurance Account (if the amounts escrowed are not part of the General Operating Account);
- Reserve Account;
- Security Deposit or Membership Fee Account (if applicable); and
- For cooperative projects, a Patron Capital account.

Each of these accounts serves a different purpose, as is described in the paragraphs that follow.

## **A. General Operating Account**

The borrower must establish a general operating account to handle all revenues and expenses associated with project operations. Authorized expenses payable from this account include expenses that are directly attributable to project operations and are necessary to carry out successful project operations. For a full list of acceptable expenses, see **Attachment 4-A**.

In addition, the borrower is required to deposit in the general operating account a minimum of two percent of the total project development costs. These funds must be deposited at loan closing or start of construction (whichever occurs first). This Initial Operating Capital is to be used for initial operating expenses such as advertising, insurance, fidelity coverage, and initial lease-up expenses. The funds may also be used to meet project obligations such as debt payments and reserve deposits until cash flow is sufficient to fund these accounts.

Between the project's second and thirteenth year, borrowers may request that these funds be returned if the project is showing sufficient cash flow to cover all obligations, including funding the reserves. Withdrawals may be made in a lump sum or in annual increments between the second and thirteenth year. More detail on Initial Operating Capital is provided in Section 2.

## **B. Tax and Insurance Escrow**

The borrower must deposit money, on a monthly basis, in escrow to pay required taxes and insurance. Generally, these funds can be kept in the general operating account as long as they are tracked separately from other general operating funds to ensure that funds are available to pay taxes and insurance. In some cases, however, RHS may require a separate account for taxes and insurance to ensure the availability of these funds. See Chapter 3 for a discussion of insurance requirements and taxes.

## **C. Reserve Account**

The reserve account is funded through monthly contributions from project operating funds. It is used primarily to pay for large planned expenses for maintenance and improvements of capital items. The administration of project reserves is covered in detail in Section 3.

## **D. Security Deposit or Membership Fee Account**

The security deposit or membership fee account holds funds provided by residents as security deposits and membership fees. See Chapter 7 for a full discussion of security deposits and membership fees.

- **Uses of funds.** Funds deposited in the security deposit/membership fee account must be used for purposes outlined in the management plan.

- ◇ The borrower may only use security deposits to cover costs of fixing damage to unit beyond ordinary wear and tear by the tenant who provided the deposit. The funds must be returned to the tenant if not used. If the borrower cannot locate tenant to return his or her deposit, these funds must be deposited in the general operating account or handled in accordance with applicable state laws. In cooperatives, the return of membership fees is dependent upon the legal instruments governing the project.
- ◇ Funds retained by the borrower as a result of a lease or occupancy violation must be transferred to the general operating account and treated as project income.
- **Interest.** The interest on security deposit/membership fee accounts is handled in accordance with state law. If no state law governs the use of interest, it must be deposited in the general operating account, at least once annually, and used for general operating expenses. In no case may interest accrue to the benefit of the borrower or management agent.

#### **E. Patron Capital Account**

In cooperative projects, borrowers must establish a patron capital account to hold excess operating funds in trust for cooperative members.

- Any funds in excess of three months of average operating expenses remaining in the general operating account at the end of the fiscal year must be deposited in the patron capital account. This account must be interest bearing and must be administrated according to state laws governing patronage capital.
- Each member of the cooperative must be assigned an equal portion of the funds in this account. These funds are held in trust for the members of the cooperative until they terminate their membership in the cooperative. Members may receive their portion of the funds only if they have paid all membership charges and costs due the cooperative.

### **4.4 MONITORING THE ACCOUNTING SYSTEM**

Loan Servicers must monitor project accounting systems to ensure that proper accounts are established and that these accounts are maintained in accordance with program requirements and the project's loan agreement/resolution.

There are five specific circumstances when Loan Servicers must review a project's accounting system and project accounts as described below.

#### **A. Review of the Management Plan.**

When examining a borrower's management plan for a project, Loan Servicers must review the description of the accounting system to ensure that it addresses the requirements listed in paragraph 4.1. In particular, Loan Servicers must ensure that:

- The system ensures separate accountability, i.e., it allows for separate tracking of funds for different projects owned by the same entity.
- The system handles interest correctly and in a manner consistent with state law.

For a full discussion of the review of the management plan, refer to Chapter 3.

## **B. Pre-Occupancy Meeting**

The pre-occupancy meeting is held before the project begins the lease-up process. It represents a chance for the Loan Servicer to explain program requirements, including accounting requirements, to the borrower. In particular, the Loan Servicer should describe the accounts that must be established, acceptable accounting methods and institutions, and the need for separate accountability. If the borrower has already established the accounts, the Loan Servicer should examine statements from the financial institution to ensure that all appropriate accounts were established. (For a full discussion of the pre-occupancy meeting, see Chapter 9, Loan Closing and Project Lease-up, of the Loan Origination Handbook.)

## **C. Post-Occupancy Visit**

As part of the post-occupancy visit, the Loan Servicer must confirm that the borrower has established the appropriate accounts and is making the required deposits. The Loan Servicer must examine the borrower's bank statements to ensure that accounts were established and that they were established in a proper institution with proper insurance. The procedures for this visit are described in Chapter 9, Loan Closing and Project Lease-up, of the Loan Origination Handbook.

## **D. Quarterly and Monthly Reports**

Quarterly and monthly reports provide an opportunity to check on the status of project accounts of new and troubled projects on a regular basis. The Agency does not expressly require submission of these reports except from projects during their first 12 months of operation or from troubled projects. When reviewing these reports, Loan Servicers must verify account information and take the following actions:

- Confirm that the account balances provided on the reports are appropriate. For example:
  - ◇ Are the reserves reported at the appropriate level as specified in the loan agreement/resolution?
  - ◇ Does the balance in the security deposit/membership account appear appropriate for the number of tenants and the amount required for deposits/fees?
  - ◇ Do the tax and insurance escrow reflect appropriate monthly deposits and appropriate withdrawals? (Taxes may be due monthly, quarterly, biannually, or annually.)

- ◇ Have there been any dramatic, unexplained changes in the General Operating Account?
- Confirm that the funds are deposited in accounts that are backed by either of the following:
  - ◇ FDIC insurance coverage;
  - ◇ Collateral pledges of amounts above FDIC limits; or
  - ◇ Other coverage against theft or dishonesty.

#### **E. Budget Review**

During the review of the budget, Loan Servicers must evaluate the borrower's plans for funding, maintaining, and using the accounts to determine if the budget is realistic and reasonable. See paragraph 4.21 for more information.

#### **F. Annual Financial Reports**

The review of the annual financial reports provides the most detailed information on the status of project accounts. The annual financial report looks specifically at the accounting system to confirm that the required accounts are properly maintained and tracked separately. The annual financial report also looks at each account to make sure that deposits and withdrawals comply with programs rules (i.e., that funds were expended for proper purposes and all required payments and deposits were made.) In reviewing the annual financial report, the Loan Servicer is able to obtain information about the financial stability of the project. If the report indicates that there is a negative trend in the project's finance, this alerts the Loan Servicer to review project operations more closely.

## **SECTION 2: INITIAL OPERATING CAPITAL AND BORROWER RETURN ON INVESTMENT [7 CFR 3560.305]**

### **4.5 INTRODUCTION**

This section is about a special fund, known as Initial Operating Capital, that the Agency requires to protect the security of the project during its initial years.

### **4.6 PURPOSE**

The period between initial occupancy and full rent-up in a project can be risky because rental income may not be sufficient to cover all operating costs, make payments on the Agency loan, and make required contributions to the reserve fund. In addition to these regular operating expenses, there are some special expenses associated with this period such as purchasing furniture or equipment for public spaces or advertising and marketing. To assist projects through this phase, the Agency requires the establishment of a fund for Initial Operating Capital.

### **4.7 CAPITALIZATION OF INITIAL OPERATING CAPITAL**

All borrowers must provide Initial Operating Capital equal to at least two percent of the loan amount to support initial operation of the project. Limited-profit borrowers must put this amount down at the loan closing or construction start, whichever comes first. The Agency loans the required two percent to not-for-profit borrowers. (For details on this process, see the Loan Origination Handbook.) Borrowers provide the Agency with a list of proposed uses for Initial Operating Capital during loan origination.

### **4.8 ACCOUNTING FOR INITIAL OPERATING CAPITAL**

When the project accounts are established, Initial Operating Capital is blended with other revenue and used for operating expenses.

The borrower may leave an amount of money equal to the initial capitalization of the fund in the operating account. This money should not be treated as excess funds in the operating account nor should it be transferred to reserves. In addition, its presence in the operating account should not be used as justification to deny a rent increase.

### **4.9 DURATION OF INITIAL OCCUPANCY**

The initial occupancy phase lasts until the project has attained a stable occupancy rate and the operating budget can reliably be supported by rental income. Projects vary as to when they achieve this stability; the Agency anticipates it occurring sometime between the end of the second and the thirteenth year of occupancy. At that point a for-profit borrower whose cash contribution created the Initial Operating Capital may request the contribution be repaid.

## **4.10 REPAYMENT**

### **A. Agency Policy**

The borrower may, with the consent of the Agency, withdraw its original contribution to the Initial Operating Capital in a single installment between the second and thirteenth full year of project operation, provided the borrower can satisfy Agency criteria for approving repayment. Repayment can only be made once the project has been operating for two years and the project's operations and finances have stabilized. Repayment must be made during the initial operating phase, which ends at the close of year 13. Repayments may be in one to five installments, until the borrower's contribution to Initial Operating Capital has been fully repaid. The financial condition of the project may preclude full repayment of Initial Operating Capital.

The borrower must be able to demonstrate that the project is financially stable, that repayment will not require a rent increase, and that the project is in compliance with Agency requirements.

### **B. Borrower Submissions**

- The borrower may submit a request for repayment of Initial Operating Capital with its transmission of the annual financial report.
- The borrower's request is submitted in writing and addressed to the Servicing Office.
- The submission includes a narrative demonstrating how the project meets Agency criteria for repayment:
  - ◊ The project's financial position is stable.
  - ◊ The project has averaged 90 percent occupancy over the most recent 12 months.
  - ◊ Contributions to reserves are on schedule.
  - ◊ There are no outstanding compliance violations.
  - ◊ The project is not under a work-out agreement.
  - ◊ Repayment will not require a rent increase.
- The submission should specify the amount of the repayment the borrower is requesting in the current year, and, if applicable, the borrower's plan for completing repayments in ensuing years.

### **C. Agency Processing**

Staff examine the submission for eligibility, completeness, and compliance with the criteria the Agency has established a project must meet in order for a repayment to be



made. If staff find the project can support the repayment, an additional analysis is performed to compute the amount.

Staff may approve requests for the repayment of Initial Operating Capital only if the borrower's written request or the Agency's records demonstrate the following criteria:

- **Occupancy.** The occupancy rate for the project over the most recent 12 months has averaged 90 percent.
- **Contributions to reserves.** Contributions to reserves are on schedule, less any authorized withdrawals.
- **Sufficient income.** When the amount of the repayment is subtracted from the general operating account the ending cash balance still includes an amount equal to 10 percent of projected annual operating costs, and all required payments for taxes and insurance.
- **Impact on rents:**
  - ◇ Repayment is denied if it creates a shortfall in operating income that must be made up by a rent increase.
  - ◇ There is no issue if no rent increases are projected in the year the repayment is made.
  - ◇ A rent increase will not affect repayment if rents are increasing to cover increases in costs, such as wages, taxes, or insurance.

### ***1. Amount of Repayment***

The borrower may receive an amount equal to the original contribution of Initial Operating Capital or a smaller installment if the operating budget cannot support repayment in a single installment.

<b>Example</b>			
	Case One	Case Two	Case Three
Year End Cash Balance	\$57,000	\$40,000	\$27,000
10% O&M Requirement Plus Taxes & Insurance	27,000	27,000	27,000
IOC	30,000	30,000	20,000
<b>Repayment Amount</b>	30,000	13,000	30,000
IOC Unpaid Balance	0	17,000	30,000
The borrower in Case One can be repaid in a single installment. The borrower in Case Two would require three installments, assuming little change in the project's financial condition. The borrower in Case Three could not receive any repayment this year.			

## 2. *The Decision Process*

- The Servicing Office has 60 calendar days to review the annual financial statement, including the request for repayment of Initial Operating Capital.
- The Servicing Office may decide to:
  - ◊ Permit repayment in the amount requested by the borrower;
  - ◊ Permit repayment, but in an amount less than that requested by the borrower; or
  - ◊ Refuse repayment because the project does not meet the criteria for repayment.
- The decision of the Servicing Office is transmitted in a letter to the borrower. In addition to the amount, if any, of the authorized repayment, and/or the reasons for denying repayment, the letter states the amount of any remaining unpaid balance of the original contribution to Initial Operating Capital.
- MFIS is updated to show the amount of the authorized repayment, and the unpaid balance of Initial Operating Capital.

### 4.11 RETURN ON INVESTMENT (ROI)

The borrower may take the ROI before withdrawing the original contribution to operating capital. Borrowers may receive a return on their investment (ROI) in accordance with the terms of their loan agreement and the following:

- The borrower may take the ROI immediately after the project's fiscal year ends if there is a positive net cash flow and the balance of the reserve account is equal to or greater than required deposits minus authorized withdrawals. If the annual financial reports indicate that the borrower should not have taken an ROI, the Agency will require the borrower to return the unauthorized ROI to the project.
- If the project's operations show a negative cash flow, the Agency may authorize the borrower to take the ROI only after the Agency has reviewed the project's annual financial report and determines:
  - ◊ There is surplus cash in either the general operating account or the reserve account.
  - ◊ The housing project has sufficient funds to address identified capital or operational needs.

## **SECTION 3: REPLACEMENT RESERVES [7 CFR 3560.306]**

### **4.12 PURPOSE OF RESERVES**

The Agency has a financial interest in a project over the life of its loan. During this period, which can be as long as 50 years, major replacements and capital expenditures will have to be made to the building such as replacing the roof, rewiring, replacing windows, major exterior work, and new kitchen and bathroom fixtures. If these expenditures are not made the property loses value, becomes less attractive to tenants, begins to deteriorate, and the Agency's financial interest is at risk.

In most cases, such expenditures cannot be met out of annual operating income. Therefore, the Agency requires that a certain amount of rental income each month be deposited in a special interest-bearing savings account (called a Reserve Account) with rates greater than or equal to passbook savings or checking accounts. The Agency's expectation is that over time, the accumulation of funds in this account will be sufficient to meet these major capital costs. Adequate replacement reserves are a critical component of a successful project.

### **4.13 ESTABLISHING THE RESERVE AMOUNT**

All borrowers must make a monthly contribution to the reserve account in an amount established by the Agency at loan closing. During the loan origination phase the Agency determines the total amount that should be in the reserve account, called the "fully funded level" and the monthly contribution that this level requires. The monthly amount is established in the borrower's loan agreement/resolutions.

#### **A. Pre-1999 Projects**

For pre-1999 projects, the Agency's policy has been to set the fully funded level at an amount equal to 10 percent of the loan. This amount is to be achieved by making equal monthly installments over 10 years. Thus, a project with a \$1,200,000 loan is fully funded when the reserve account reaches \$120,000. This level requires annual contributions of \$12,000 or monthly contributions of \$1,000 for 10 years.

#### **B. Post-1998 Projects**

The Agency is developing a policy for new projects that will use an analysis of life-cycle costs to establish the fully funded level of the reserve account. An analysis of the local rental market will be used to establish the required monthly contribution to reserves. Monthly contributions must be limited to a level where basic rents charged to tenants do not exceed conventional rents for comparable units in the market. This policy may increase the fully funded level and stretch out the number of years in which payments to reserves are required.

### **4.14 DURATION OF THE ANNUAL CONTRIBUTION REQUIREMENT**

The borrower must continue making contributions to the reserve account until it is fully funded and the balance remains at 10 percent of the loan or at the fully funded amount shown on

the Loan Agreement/Resolution or any Addendum. If reserves are used and the amount in the reserve account falls below the fully funded level, contributions must be reinstituted until the Reserve Account once again reaches the fully funded level.

#### **4.15 MONITORING THE RESERVE ACCOUNT**

##### **A. Quarterly Reviews**

On a quarterly basis, for projects that are designated as troubled or are in their first twelve months of operation, borrowers provide evidence to the Field Office of contributions to the reserve account. Borrowers of all other projects are to provide this evidence to the Field Office on a semiannual basis. Loan Servicers must review this information to verify that the required deposits were made. Interest earned on the account during the six months counts toward meeting the required contribution level. The Loan Servicer must follow up with borrowers whose payments are behind schedule.

##### **B. Annual Reviews**

During its review of the annual financial report, the Servicing Office reviews *Form RD 1930-7, Multi-Family Housing Project Budget*, using MFIS to verify the information supplied in the engagement.

The critical factor in the review of *Form 1930-7, Multi-Family Housing Project Budget*, is to establish whether the borrower has met the annual contribution requirement to the account:

- The borrower is in compliance if the required annual contribution (which includes annual interest earned on the account) has been made, there have been no withdrawals, and the account is on schedule towards being fully funded.
- The borrower is also in compliance if the required annual contribution has been made and there have been authorized withdrawals from reserves, even if the withdrawals have put the account behind the original schedule for being fully funded.
- The borrower is out of compliance if the annual contribution is less than the required amount or if there have been unauthorized withdrawals from the reserve account.

## 4.16 THE EFFECT OF WITHDRAWALS

### A. After the Reserve Account is Fully Funded

If the account is fully funded, and the borrower makes an authorized withdrawal that reduces the balance in the account below the fully funded level, the borrower must resume making annual contributions until the account is fully funded.

### B. Before the Reserve Account is Fully Funded

If the Agency approves a withdrawal before the account is fully funded, the period during which contributions are required is extended until the account is fully funded.

#### Examples

**After reserve is fully funded.** A reserve account was fully funded by its eleventh year with annual contributions of \$12,000. The borrower withdrew \$20,000 in year 14. The borrower is required to make a \$1,000 monthly contribution to reserves for 20 months in years 14 and 15 to rebuild the account balance to \$120,000.

**Before reserve is fully funded.** If the \$20,000 withdrawal in the previous example occurred in year 5, the borrower would be required to continue making annual contributions in years 11 and 12 until the reserve account was fully funded.

## 4.17 DETERMINING THE EXISTENCE AND USE OF SURPLUS OPERATING FUNDS [7 CFR 3560.306(d)]

### A. Determining the Existence of Surplus Funds

The Agency deems that the general operating account contains surplus funds when the account balance at the end of the project's fiscal year exceeds 10 percent of the sum of the following:

- Operating and maintenance expenses, including debt service.
- Transfers to reserves.
- A return to the borrower, including repayment of the borrower's contribution to initial operating capital, if it has not been repaid.

If the borrower is escrowing taxes and insurance premiums, the premiums should not be included as operating expenses, although the amount that the borrower must escrow by the end of the year should be included in the calculation.

### B. Use of Surplus Funds Before the Reserve Account is Fully Funded

If the borrower has surplus funds in the general operating account at the end of the project's fiscal year, the Agency may require that the borrower transfer the surplus into the reserve account if that account is not fully funded.

### **C. Use of Surplus Funds After the Reserve Account is Fully Funded**

If the project has surplus cash in the general operating account at the end of the project's fiscal year and the reserve account is fully funded, the Agency may require the borrower to use the surplus funds to:

- Address the project's capital needs.
- Reduce project rents in the upcoming year.
- Reduce the mortgage debt the borrower owes to the Agency.

The Agency will fully consider the needs of the property and the residents before deciding how the borrower should use the surplus funds from the general operating account. If the property has physical needs that cannot be addressed from the reserve account, even if the account is fully funded, the Agency should required the borrower to use the surplus funds to address these needs.

If the property does not have unmet capital needs that cannot be addressed from the reserve account, the Agency should require the borrower to reduce rents in the upcoming year if:

- Rents exceed comparable rents for unconventional units;
- Tenants are paying in excess of 30 percent of adjusted gross household income toward rent; and
- The property has vacancies in excess of 10 percent.

If the property has no unmet physical needs that cannot be addressed from the reserve account and the rents are reasonable, the Agency should require the borrower to use the surplus funds from the general operating account to reduce the borrower's mortgage debt to the Agency.

## **4.18 CHANGES IN RESERVE REQUIREMENTS**

Over the life of a project, the Agency may recommend that the borrower request a change in the amount required for the reserve account to be fully funded, and/or the required annual contribution to the account. Such a change will usually be the result of the Agency or the borrower recomputing the amount of reserves the project needs, using a long-term capital plan based on an analysis of the life-cycle replacement and repair costs of the project.

The Agency must review the adequacy of the reserve contributions when considering a workout agreement with the borrower or when considering any action that requires re-underwriting, such as reamortization or writedown.

If an increase to the reserve account funding level would result in the need for a rent increase, the borrower must submit the request to increase reserve contributions in accordance

with the annual budget cycle. In approving an increase to the reserve account funding level, the Agency will consider the housing project's approved budget and ability to support increased reserve account deposits. An increase in reserve account deposits must not result in a rent increase that would raise the basic rent level above conventional rents for comparable units in the area.

#### **4.19 FINANCIAL MANAGEMENT OF THE RESERVE ACCOUNT**

##### **A. Supervised Account**

All borrowers must deposit reserve contributions into a supervised account in which the Agency is the coexecutor of the deposit agreement and the cosigner of all checks. This policy has been established to protect the security of the reserve account.

The Field Office monitors reserve accounts to determine whether the borrower makes the requisite deposits and uses the funds for authorized purposes only.

The Field Office must designate the co-signer for each project it supervises and communicate this information to the bank where the reserve account is held. It is important to identify the cosigner when the account is established, so that legitimate invoices can be paid in a timely fashion from the reserve account. The Field Office retains a copy of the executed deposit agreement establishing the account in the project file.

##### **B. Where the Account May Be Held**

The reserve account must be held either at a Federally insured domestic institution such as a bank, savings and loan association or credit union, or at a domestic institution authorized to sell securities.

##### **C. Insurance Requirements**

Project reserve funds must be held in accounts that are insured against theft and dishonesty.

##### **D. Using Reserves to Invest in Securities**

The Agency permits reserves to be invested in securities but only within prescribed limits that minimize the risk such investments may pose:

- Any securities in which reserves are invested must be backed by the U.S. Government, or an agency of the government, or be triple-A rated Government National Mortgage Association collateralized tax-exempt bonds.
- The borrower must record the price actually paid for the securities, which must equal the required contribution to reserves.

- Investors must be knowledgeable about industry practices and consider the impact of typical fees and charges for purchases, sales, and maintenance of an account, when making investment decisions. Such fees may be paid out of reserves, as long as they are reasonable. The Agency may review such fees when approving the project's annual budget. Project proceeds may not be used to pay for the services of a financial adviser.
- Approved withdrawals from the reserve account may require the sale of securities in an amount that results in proceeds sufficient to cover the disbursement. Should unusual circumstances require the sale in unfavorable market conditions, the borrower will not be required to reimburse the project for any losses incurred.

The Servicing Officer uses the annual audit report to monitor compliance with these requirements.

#### **E. Excess Reserves**

Once the Agency is assured that there is enough money in the reserve account to pay for anticipated capital expenditures over the life of the loan, it will not encourage further growth of the account. These funds may be used instead to reduce its exposure in the project or to make the project more competitive in its rental market.

The Servicing Office may direct the borrower to transfer substantial excesses that have accumulated in a fully funded reserve account on a project which is following a planned schedule for making major capital improvements. Possible uses for such excess reserves include:

- To speed up or make additional payments on the Agency loan, in accordance with allowable servicing actions;
- To reduce project rents; and
- To pay the borrower's accrued equity as an incentive to extend the low income use of the property.

### **4.20 ANNUAL INTEREST WITHDRAWAL [7 CFR 3560.306(i)(3)]**

#### **A. Agency Policy**

Borrowers operating on a for-profit or a limited profit basis may make an annual withdrawal from the reserve account of up to 25 percent of the interest earned on the account during the prior year. This withdrawal serves to offset income taxes payable by the borrower as a result of the interest earnings on the account, and is not a withdrawal to provide a return on investment.

Borrowers will be required to repay the reserve account if the withdrawal reduced the amount in the account below the fully funded level or if, as a result of the withdrawal,



required contributions are behind schedule. Repayment must occur by the end of the fiscal year in which the withdrawal occurred.

If the Agency has notified the Borrower that all or part of the interest withdrawal must be repaid to the reserve account, the Borrower must comply with this requirement in order to be eligible to request a similar withdrawal in the ensuing fiscal year.

## **B. Borrower Submission**

The borrower submits a letter requesting the withdrawal at the time of the annual financial report submission. The request should include information on the amount of interest earned in the account in the previous year, demonstrating that the requested withdrawal does not exceed 25 percent of the interest earned and credited to the account. The request should be accompanied by a two-party check drawn on the reserve account and payable to the borrower in the amount of the requested interest withdrawal.

## **C. Agency Processing**

These withdrawals are treated as any other reserve withdrawal. (See also Chapter 5, paragraph 5.8.) The Servicing Office reviews the request for eligibility:

- To verify the amount meets the 25 percent standard; and
- To verify that contribution to the reserve account have been on schedule, including any repayments the Agency may have required the borrower to make for previous withdrawals of interest income.

The Servicing Officer calculates whether the borrower must repay any or all of the interest withdrawal back to the Reserve Account.

- If the reserve account is fully funded, the Servicing Officer must calculate whether the withdrawal will reduce the balance below the fully funded level (see Example A).

<b>Example A</b>			
<b>Year 14: Reserves are Fully Funded</b>			
	Case One	Case Two	Case Three
Required Fully Funded Balance	\$120,000	\$120,000	\$120,000
Actual Balance	\$125,000	\$120,000	\$120,500
Interest Withdrawal Amount	\$1,562	\$1,500	\$1,500
Balance After Withdrawal	\$123,437	\$118,500	\$19,000
Amount of Additional Contributions Needed	None	\$1,500	\$1,000
In Case One, the surplus in the reserve account exceeds the amount of the withdrawal and no repayment is required. In Case Two, there is no surplus and the full amount of the withdrawal must be repaid. In Case Three, the surplus in the account reduces the amount of the interest withdrawal that must be repaid.			

- If the borrower is still making annual contributions to the Reserve Account, the Servicing Officer must calculate whether the withdrawal will reduce the balance below the amount required in annual contributions (see Example B).

<b>Example B</b>			
<b>Year 5: Annual Contributions Still Required</b>			
	Case One	Case Two	Case Three
Required Annual Contribution	\$12,000	\$12,000	\$12,000
Actual Contribution	\$13,000	\$12,000	\$12,500
Interest Withdrawal Amount	\$750	\$750	\$750
Annual Contribution After Withdrawal	\$12,250	\$11,250	\$11,750
Required Contribution in Year Six	\$12,000	\$12,750	\$12,250
In these cases, any repayment of interest withdrawal is added to the required annual contribution to the reserve account.			

The Servicing Officer responds in writing to the borrower's request:

- If the Servicing Office has approved the withdrawal in the amount requested by the borrower, the written response must specify the amount, if any, the borrower will be required to repay the reserve account by the end of the current fiscal year.
- If the Office has determined the borrower is ineligible for an interest withdrawal, the letter must specify the reason.
- If the amount of withdrawal approved by the Servicing Office is not the same as the amount requested by the borrower, the letter must explain the reason for the difference.

The Servicing Office must complete its review within 10 calendar days of the request.

## SECTION 4: PROJECT BUDGETS

### 4.21 BUDGET REQUIREMENTS [7 CFR 3560.303]

Project budgets are planning documents that provide a picture of project financial operations. They reflect the project's expected revenues and expenses including plans for maintenance, capital improvements, reserve account activity, and the owner's return for the coming year.

Borrowers must submit annual project budgets to the Agency for approval. Budgets must meet the following requirements:

- Budgets must be reasonable and realistic. Revenues and expenses must be consistent with past project budgets and comparable projects. Any differences must be due to legitimate operating needs of the project.
- Project expenses can include only expenses necessary to maintain successful projects. (An example of an unnecessary expense is owner or manager entertainment expenses.) Project expenses cannot be used for unearned personal benefit or gain, or for reimbursement of false or inaccurate expenses.
- The borrower must not include expenses for purposes unrelated to the housing project or for fines, penalties, and legal fees where the borrower has been found guilty of violating laws such as civil rights, evictions, and building codes.
- The borrower is responsible to submit project budgets that address the project's physical accessibility needs. The Loan Servicer may approve the cost of providing accessible rental housing as an authorized use of project funds.
- The borrower must not include organizational expenses among project expenses. These items are covered by the management fee. (For a list of items covered in the management fee, see **Attachment 3-F**.)
- Nonprofits and cooperatives may request a reasonable fee for borrower oversight functions such as:
  - ◊ Board of Director's review and approval of proposed budgets, including proposed repairs, outlays, and accruals;
  - ◊ Review of capital expenditures over \$500;
  - ◊ Approval of annual financial reports and considerations of any management comments noted; and
  - ◊ Long-term asset management reviews.
- The priority order of project expenditures must be:
  - ◊ Operating and maintenance expenses, including taxes and insurance;

- ◇ Debt service to the Agency;
- ◇ Reserve account deposits;
- ◇ Other authorized expenses; and
- ◇ Return on the owner's investment.

#### **4.22 SCHEDULE FOR BUDGET REVIEW AND APPROVAL**

The schedule for submitting budgets depends on whether the proposed budget includes a rent change or not. Budgets with rent increases require extra time for approval. Exhibit 4-1 outlines the schedule for budgets with and without rent increases. **Attachment 4-B** provides a flowchart for the process.

##### **A. Agency Review Time**

The total Agency review time for a budget from submission to initial approval or rejection is:

- 30 days for budgets without rent increases
- 45 days for budgets with rent increases

If the initial budget is rejected, this schedule allows for a second review of the budget and approval (if appropriate) before the start of the fiscal year.

##### **B. Late Budget Submissions**

The schedule provided for budget reviews relies on timely submission of budget documents by the borrower. If the borrower is tardy in submitting required documents, the Agency cannot ensure that all deadlines will be met. Therefore, if a borrower submits the budget late, Agency deadlines no longer apply and the borrower is not eligible for “automatic approval” of the budget (as discussed in paragraph 4.31). If no budget is approved by the end of the project's fiscal year, the borrower must operate under the previously approved budget until the Agency reviews and approves the new budget.

**Exhibit 4-1****Schedule for Budget Submission and Review**

<b>Budgets Without Rent Increases</b>	
60 days prior to end of the project's fiscal year <i>November 1*</i>	Borrower submits budget documents to Agency. <ul style="list-style-type: none"> <li>Agency conducts completeness review within ten days (<i>November 11</i>)</li> <li>Borrower has 10 days to provide additional information (<i>November 21</i>)</li> <li>Agency has 30 days total to review the complete budget (<i>December 1 if budget was received on time</i>)</li> </ul>
30 days prior to end of fiscal year <i>December 1</i>	Agency approves or denies the budget.** <ul style="list-style-type: none"> <li>If the budget was denied, the borrower may submit additional information to address deficiencies within 10 days (<i>December 11</i>)</li> <li>Agency makes final approval or rejection of budget within 20 days of receipt of this information (<i>December 31</i>)</li> </ul>
End of fiscal year <i>December 31</i>	Final approval or rejection of the budget. If budget is denied, the previous year's budget remains in effect.
<b>Budgets With Rent Increases</b>	
105 days prior to end of fiscal year <i>September 15*</i>	Borrower submits budget documents to Agency and notifies tenants of requested rent increase. <ul style="list-style-type: none"> <li>Tenants have 20-day comment period to get back to the borrower (<i>October 5</i>)</li> <li>Borrower has 5 days to compile and submit comments to the Agency (<i>October 10</i>)</li> <li>Agency has 15 days to perform the completeness review (<i>October 1</i>)</li> <li>Agency has 45 days total to review the budget (<i>October 31</i>)</li> </ul>
90 days prior to end of fiscal year <i>October 1</i>	Agency finishes the completeness review and informs the borrower of any missing items. <ul style="list-style-type: none"> <li>Borrower has 10 days to provide additional information (<i>October 10</i>)</li> </ul>
60 days prior to end of fiscal year <i>October 31</i>	Agency provides notice to the borrower of budget approval or rejection.** <ul style="list-style-type: none"> <li>If the budget was denied, the borrower may submit additional information to address deficiencies within 10 days (<i>November 10</i>)</li> <li>Agency has 20 days to review the additional information (<i>November 30</i>)</li> </ul>
30 days prior to end of fiscal year <i>November 30</i>	Final approval or rejection of the budget. <ul style="list-style-type: none"> <li>If the budget is approved, tenants must have 30 days' notice before the rent increase takes effect. (If the notices given to tenants at the outset stated the amount of the effective increase, then notice has been given).</li> <li>If the rent increase is denied, the borrower may submit a revised budget at previously approved rents with expenditures acceptable to the Agency. In the absence of such a revised budget, the prior year's budget will go into effect.</li> </ul>
Beginning of project's fiscal year <i>January 1</i>	New budget and rent increase take effect.

\* The dates provided are for a sample project with a fiscal year that begins January 1. For projects with different fiscal years, adjust accordingly.

\*\* If the borrower submitted the budget on time, and has not been notified by the Agency of any deficiencies by this time, the budget is considered approved unless it is not eligible for automatic approval. (See paragraph 4.31.)

### C. Steps in Budget Review and Approval Process

When reviewing and approving budgets, Loan Servicers must take the following steps, as shown in Exhibit 4-2.

#### Exhibit 4-2

##### Steps in the Budget Review and Approval Process

- Follow procedure for receipt of budgets (see paragraph 4.23)
- Review the budget for completeness (see paragraph 4.24)
- Prioritize budgets for review (see paragraph 4.25)
- Review outstanding monitoring findings (see paragraph 4.26)
- Review the budget for reasonableness (see paragraph 4.27)
- Review the reserve account (see paragraph 4.28)
- Review the rent change, if requested (see paragraph 4.29)
- Approve or deny the budget (see paragraph 4.31)

Budgets for projects that receive HUD Section 8 assistance need to be reviewed with the same rigor as other projects. However, there are certain procedures that differ. Paragraph 4.30 discusses these procedures.

### 4.23 RECEIVING THE BUDGET

Standard procedures for budget receipt will help Loan Servicers to track the progress of budgets through the approval process and meet approval deadlines. Further, intake procedures should help prioritize the review of budgets so that those with the highest priority (e.g., those with rent changes) receive in a timely manner the attention they need.

#### A. Budget Submissions

The borrower must submit a budget narrative, budget form (*Form RD 1930-7, Multi-Family Housing Project Budget*), and capital budget form (or other form as approved by the Agency) as part of the budget submission.

##### 1. Budget Narrative

The budget narrative provides a description of the budget and highlights important elements to aid Loan Servicers in their review of the budget. Items to be covered in the budget narrative are listed in Exhibit 4-3.

### Exhibit 4-3

#### Items To Be Covered In A Budget Narrative

- A brief description of the project and its status. The description should address key indicators of project status. For example it should highlight any issues concerning vacancies, unexpected maintenance, or other items that affect the budget.
- A statement of project compliance. This statement should indicate any outstanding monitoring findings and the borrower's progress in addressing these compliance problems.
- A description of the project's financial status, highlighting the project's overall financial status, important changes during the last year, and factors contributing to financial difficulties.
- An explanation of any changes in project expenses or cash sources that exceed the tolerance threshold.
- An explanation of projected capital expenditures and reserve withdrawals for the upcoming year and capital needs for the next three years beyond the budget year.
- If applicable, a statement that the proposed budget includes a rent increase and reasons for the increase. The request must include information on conventional rents for comparable units in the community, if this information is available. It must also include a summary of tenant comments on the proposed rent increase received by that time.
- Any additional documentation necessary for the Agency to establish that applicable Agency requirements have been met.

#### 2. *Form RD 1930-7, Multi-Family Housing Project Budget*

This Agency form outlines the budget by line item and provides information on cash sources and uses, including rents and reserves.

#### 3. *Capital Budget Form*

The capital budget form provides information on plans for capital improvements. It lists all the capital items in the project and provides space for the borrower to indicate their condition and any needed improvements.

#### B. Procedures for Receiving Budgets

When Loan Servicers receive budget submissions, they should take the following steps:

- The Servicing Official should date stamp them, enter them into MFIS, and forward them to the appropriate Loan Servicer.
- When the borrower's notification of intention to request a rent increase is received the Loan Servicer should establish a rent change folder for tenant comments.

- When tenant comments are received, the Loan Servicer should review, record, and file them.

The Loan Servicer may use the MFIS Report “Budget Approval Review” to assist with the steps outlined in paragraphs 4.26 through 4.31.

#### **4.24 COMPLETENESS REVIEW**

The completeness review is a brief examination of the budget submissions to ensure that they are complete; it does not involve any assessment of adequacy.

##### **A. Time Frame for the Completeness Review**

Loan Servicers must finish completeness reviews within the following time frames:

- For budgets with no rent increase, the Loan Servicer must finish the completeness review within 10 days of the budget submission.
- For budgets with a rent increase, the Loan Servicer must finish the completeness review within 15 days of the budget submission.

##### **B. Procedures for the Completeness Review**

The following items must be checked in the review:

- Verify that all required items in the budget narrative have been addressed. [See Exhibit 4-3 for a listing.]
- Review *Form RD 1930-7, Multi-Family Housing Project Budget* to verify that all appropriate line items are completed. Perform a quick assessment to ensure that they appear to be completed properly.
- Verify that the capital budget form is complete. Capital improvements needed to implement a borrower’s transition plan should be included as part of the capital budget portion of *Form RD 1930-7, Multi-Family Housing Project Budget*, when applicable (for information regarding transition plans, please see paragraph 3.4). Compliance related costs include reasonable fees and costs for preparing self-evaluations and transition plans.

If the budget is complete, the budget review should continue as described in the following sections. If the budget is incomplete, the Loan Servicer must take the steps described in paragraph C below.



### C. Incomplete Budgets

If any of the items discussed above are missing or are of such poor quality that there is insufficient information to begin an assessment of the budget, the budget is considered incomplete.

If the budget submission is incomplete, the Loan Servicer must send a letter to the borrower stating that the budget is incomplete and listing the deficiencies.

**Good Practice:  
Start Your Review Right Away**

A budget that is missing a small amount of information can still be reviewed. Prioritize the budget for review as described in paragraph 4.25 and begin to assess the budget as feasible given the information provided.

- The letter should state that the borrower then has 10 days to submit new information.
- If the borrower does not submit the information within the 10-day time period, the Agency cannot guarantee approval of the budget before the beginning of the new fiscal year. In these cases, the borrower must continue operations under the previous year's budget until a budget is approved. The borrower is not eligible for automatic approval as described in paragraph 4.31.
- If the borrower does submit the information within 10 days, the budget is considered to be on time and the review can still be completed prior to the end of the fiscal year. The budget is eligible for automatic approval, as described in paragraph 4.31.

#### 4.25 PRIORITIZING BUDGETS FOR REVIEW

After budgets have been received and determined to be complete, the Loan Servicer should prioritize budgets for review. Prioritizing the budgets helps to ensure that the budgets that require the most thorough review receive the attention they need. Budgets with the highest priority for review include budgets for projects with:

- Requests for rent increases above \$25;
- Vacancy rates above the allowable threshold (see paragraph 4.27 B for an explanation of this threshold); and
- Past monitoring findings.

While Loan Servicers should place the highest priority on reviewing these budgets, they should plan their time to allow for sufficient review of all budgets.

#### 4.26 REVIEWING OUTSTANDING COMPLIANCE ISSUES

Having determined that the budget submission is complete, the Loan Servicer must check the project for outstanding compliance findings and assess whether borrower's budget narrative reflects adequate efforts to address these findings.

Specifically, the budget narrative must discuss the following issues and explain how they are addressed in the proposed budget.

- Any outstanding findings from last year’s annual financial report;
- Outstanding findings from recent physical inspections or supervisory visits (to be renamed occupancy and management/administration reviews); and
- Work out agreement (if applicable).

If the outstanding monitoring issues have been adequately addressed in the budget narrative, the Loan Servicer should proceed with the review for reasonableness (see paragraph 4.24). If project compliance issues have not been addressed, the budget documents should be returned to the borrower for revision.

#### **4.27 REASONABLENESS REVIEW**

If all outstanding compliance issues have been addressed, the Loan Servicer must review the budget for reasonableness. The Loan Servicer must use the steps outlined in Exhibit 4-4 to make a determination of reasonableness. To guide the reasonable review, the Loan Servicer should use the *Multi-Family Housing Budget Approval Review* form.

##### **A. Tolerance Threshold**

In reviewing the proposed budget, Loan Servicers must apply a tolerance threshold of 10 percent. This means that when Loan Servicers perform the reasonableness analysis, if specific budget items (as identified in Exhibit 4-4) differ from the appropriate benchmark by more than 10 percent, they are considered to exceed the tolerance threshold and require additional analysis as described in paragraph D.

##### **B. Reasonable Vacancy Allowance**

A vacancy allowance is considered reasonable if it does not exceed the historical vacancy rate in the property plus an additional two percent (to allow for unpredictable changes in vacancies). However, the vacancy rate is capped at the following levels:

- For projects with 15 or fewer units, the historical vacancy rate is capped at 10 percent (allowing for a total vacancy rate of 12 percent).
- For projects with more than 15 units, the historical vacancy rate is capped at 15 percent (allowing for a total vacancy rate of 17 percent).

##### **C. Utility Allowance Analysis**

Depending upon the rate of change in costs, the borrower must provide the following documentation describing the utility allowances:

- If utility costs have changed significantly (over 15 percent):

- ◇ Documentation of the extent of the utility rate changes. This may include billing information or documentation from utility companies; and
- ◇ A significant sampling of tenant utility usage from the utility company. If tenant utility information is unavailable from the utility company or only provided at cost, utility billings received by tenants are acceptable.
- If utility costs have changed moderately (15 percent or less):
  - ◇ Information regarding rate changes; and
  - ◇ A sampling of individual tenant utility usage.
- If there are no changes in utility rates:
  - ◇ Documentation in the annual budget indicating that no change in rates has occurred during the period being reviewed; or
  - ◇ A public release from the utility provider indicating no change in rates has occurred during the period reviewed.
- If there has been no documentation provided on utility usage for over three years:
  - ◇ Documents as if utility costs have changed significantly; or
  - ◇ Letter from utility company saying there has been no increases in rates.

#### **D. Procedures for Reviewing Cost Increase Justifications**

If the reasonableness analysis reveals that the subtotal for any operating expense category (i.e., maintenance and operating costs, utilities, administration, or taxes and insurance) exceeds the tolerance threshold, the Loan Servicer should review the budget narrative to determine whether the borrower provided adequate documentation that the expenses for this category are reasonable and necessary. For example, the borrower might provide documentation of the following:

- Costs are comparable to the costs for similar properties in the conventional market. For example, the borrower might show that insurance costs for the same coverage at a conventional project are comparable to the costs for the project shown in the budget.
- The factors contributing to the cost increases are beyond the borrower's control and the borrower is actively implementing cost containment measures. For example, the project is subject to utility rate or tax increases.
- The cost increase is needed to cover actions to address identified physical deficiencies that are not due to negligence by the borrower or the management agent. Physical deficiencies that are due to negligence by the borrower or the management agent are not acceptable reasons for a rent increase.

If the explanation for the rent increase is not acceptable, the budget should be denied in accordance with procedures described in paragraph 4.30.

#### Exhibit 4-4

##### Review for Reasonableness

The reasonableness review involves three steps as described below:

**Step 1:** Review the operating expenses, income sources, and vacancy allowance.

- Operating Expenses: Check operating subtotals (O&M, Utilities, Administrative, T&I)
  - ◊ Are operating subtotals more than 10 percent different from last year?
  - ◊ Are operating subtotals more than 10 percent different from comparable properties?
- Income Sources: Check income sources (rental and subsidy, non-rental)
  - ◊ Are income sources more than 10 percent different from last year?
  - ◊ Are income sources more than 10 percent different from comparable properties?
- Vacancy Allowance
  - ◊ Is the vacancy allowance reasonable? (Historical vacancy rate + 2 percent, up to permissible cap—i.e., 12 percent for projects with 15 or fewer units, 17 percent for projects with more than 15 units.)
- Utility Allowance
  - ◊ Has appropriate documentation been provided to justify the utility allowance?
  - ◊ Does the documentation provided demonstrate that the utility allowance is reasonable and comparable to other projects in this market area?

**If the answer to any of these questions is no, determine whether the budget narrative provides an adequate explanation for the unusual item.** (As discussed in paragraph 4.27, an adequate explanation might include evidence that other properties have comparable costs, income, vacancies, or utility allowances).

**Step 2:** Check cash uses. Does the budget reflect the:

- Correct debt payment?
- Reasonable nonoperational cash use?
- Correct reserve payment?
- Owner's return on investment?

**If the answer to any of these questions is no, the borrower must submit a corrected budget.**

**Step 3:** Look at the cash flow and ending cash balance.

- Cash flow:
  - ◊ Is cash flow positive? A negative cash flow is permissible as long as it does not appear to represent a trend that cannot be corrected.
- Cash balance:
  - If cash flow is negative, what is the ending cash? Does it cover the negative cash flow?
  - Does the ending cash balance exceed the permissible limit? If so, the excess must be contributed to reserves.

**If the analysis of cash flow and cash balance reveals a problem, appropriate servicing actions should be considered prior to budget approval.**

## 4.28 REVIEWING THE RESERVE ACCOUNT

The Loan Servicer must review the reserve account levels and contributions to ensure that they are consistent with the loan agreement. The *Multi-Family Housing Budget Review* form provides guidance on this review. This review focuses on four items:

- **Beginning balance.** The Loan Servicer should record on the Budget Review form the beginning balance of the reserve account, both the total and the per unit amount.
- **Transfers to reserves.** The Loan Servicer should check the budget to ensure that the appropriate dollar amount, as specified in the loan agreement/loan resolution, is budgeted for deposit in the reserve account. The Loan Servicer should record that amount (the total and per unit amount) on the Budget Review form.
- **Transfers from reserves.** Any transfers from the reserve account that are included in the budget should be described in the budget narrative and justified by the capital plan. The Loan Servicer should record these amounts (total and per unit) on the Budget Review form.
- **Ending balance.** The ending reserve account balance is calculated by taking the beginning balance, adding the transfers to the reserve account, and subtracting the transfers from the reserve account. The Loan Servicer should record this amount on the form as well (both total and per unit costs).

If the Loan Servicer finds that the reserve account level is not where it is supposed to be, that the budget does not show correct contributions to reserves, or that transfers from reserves are not adequately documented, the borrower must submit corrected budget documents.

## 4.29 REVIEWING THE RENT INCREASE (IF REQUESTED)

Even if the Loan Servicer has determined that the budget is reasonable, based on the tests outlined in Exhibit 4-4, the rent increase must still be reviewed to confirm that:

- The rent/utility allowance change will not adversely affect the marketability of the units and create a vacancy problem; and
- The project's basic rents do not exceed conventional rents for comparable units.

### A. Conventional Rents for Comparable Units

In establishing rents for new projects and increasing rents for existing projects, the Agency has introduced a market-based measure that serves as a standard for evaluating proposed rent increases. This measure, “conventional rents for comparable units” (CRCU), is an objective measure, specific to the quality of the unit, that reflects the local market and serves as an indicator of the project's long-term feasibility.

The CRCU standard is a benchmark meant to maintain the affordability of program units and avoid a situation where project rents are increased above local conventional

rents, leading to noncompetitive rents, excessive need for rental assistance, and/or vacancy problems.

The existence of the CRCU standard does not change the method for increasing rents. Rents remain “cost-based.” This means that they are determined based on the project budget and must be justified by actual operating costs. In most cases, the Agency expects that rents will remain well below the CRCU standard.

Similarly, the CRCU standard does not significantly alter the Agency’s process for reviewing rent increases. Loan Servicers must consider a number of factors in evaluating each rent increase. For example, the Agency looks for evidence that tenants residing in the project and potential tenants living in the market area will be able to pay the increased rent.

## **B. Reviewing the Rent Increase**

The *Multi-Family Housing Budget Review* form outlines the steps for reviewing rent increases. If this review shows that the rent increase will adversely affect the marketability of units or cause rents to increase above the conventional rents for comparable units, the full rent increase cannot be approved. The borrower should seek a reduced rent increase, and if appropriate, request a servicing action that will enable the project to achieve a positive cash flow at lower rents.

## **4.30 RENT CHANGES FOR UNITS RECEIVING SECTION 8 ASSISTANCE [7 CFR 3560.207]**

The Agency has the responsibility to review and approve project budgets annually based on need to meet cash flow and expense requirements. Therefore, the Loan Servicer cannot take into account HUD’s automatic annual adjustment for Section 8 contract rents. The Loan Servicer must approve only the rents needed to provide sufficient income to meet approved project expenses.

## **A. Reviewing Budgets With HUD Subsidies**

Since HUD and the Agency approved rental rates frequently differ, it may be necessary to have additional information for properties with Section 8 contracts. Exhibit 4-5 lists the additional information needed in the budget, depending upon the project type.

**Exhibit 4-5****Reviewing Budgets with HUD Subsidies**

<b>Project Type</b>	<b>Needed in Budget</b>
<ul style="list-style-type: none"> <li>• 100 percent Section 8/515 with interest credit; HUD contract rent rate is equal to basic rent</li> <li>• 100 percent Section 8/515 with interest credit; HUD contract rent is greater than basic rent and less than note rate rent</li> <li>• 100 percent Section 8/515 without interest credit; HUD contract rent is greater than note rate rent</li> <li>• Less than 100 percent Section 8/515 with interest credit; HUD contract rent is greater than basic and less than or greater than note rate rent</li> </ul>	<ul style="list-style-type: none"> <li>• HUD contract rent</li> <li>• Basic rent, HUD contract rent, and Agency note rate rent</li> <li>• HUD contract rent and note rate rent; difference is excess funds and deposited into reserves</li> <li>• Basic rent, HUD contract rent, and Agency note rate rent</li> </ul>

**B. Excess Rents**

When reviewing the budget, if the Loan Servicer concludes that the HUD authorized rent is more than what is needed to meet project expenses, a lesser amount than the HUD rent must be approved. When this occurs, in accordance with Exhibit 4-5, the borrower may be told to deposit the difference between the Agency-approved note rate rent and the higher HUD authorized rate into the general operating account. At the end of the year, this excess rent must be deposited into the reserve account. The manager or borrower must use *Form RD 1944-29, Worksheet for Credit and Rental Assistance* to document the required deposit in the reserve account.

**4.31 APPROVAL OR REJECTION OF BUDGETS**

Once the budget analysis is complete, Loan Servicers must notify the borrower if the budget has been approved or denied.

**A. Budget Approval**

If the Loan Servicer has determined that the borrower represents reasonable costs and has adequately addressed all outstanding compliance issues in the budget narrative, the reserve account is current, and the rent change (if requested) is acceptable, the budget may be approved. To approve the budget, Loan Servicers must sign the budget (*Form RD 1930-7, Multi-Family Housing Project Budget*) and send a copy to the borrower.

**B. Automatic Budget Approval**

Budgets that are not reviewed within the 30-day period are automatically approved unless they include a proposed rent increase that will push rents higher than conventional rents for comparable units. This automatic approval allows Loan Servicers to concentrate

efforts on budgets that need the most attention and allow budgets that can be approved without changes to move through the process.

- **Prohibitions on automatic approval.** The following budgets are not eligible for automatic approval:

- ◇ Budgets with rent increases above \$25 per unit;
- ◇ Budgets with rent increases that cause rents to rise above conventional rents for comparable units;
- ◇ Budgets that are submitted late or that miss other deadlines set by the Agency.

Loan Servicers must make every effort to review budgets with significant rent increases within the time limits. Postponing approval is not an acceptable way to address rent increases.

If a budget is not eligible for automatic approval and no decision is made prior to the beginning of the project's new fiscal year, the borrower must continue operations under the previous year's budget. In these cases, the Agency must continue to work with the borrower to address the requested increase. When agreement is reached, a new budget may take effect.

- **Time frame for automatic approval.** Automatic approval occurs within the following time frames:

- ◇ For budgets with no rent increase, automatic approval occurs 30 days after the receipt of a complete budget. Borrowers who submit budgets (with no rent increases) on time and respond to all requests for additional information within the specified time periods can consider their budgets approved 30 days after submission, if they have not received notification from the Agency.
- ◇ For budgets with rent increases, automatic approval occurs 45 days after the receipt of the original budget. Borrowers who submit budgets (with rent increases) on time and respond to all requests for additional information within the specified time periods can consider their budget approved 45 days after submission, if they have not received notification from the Agency.

- **Procedures for automatic approval.** In the case of automatic approval, the Loan Servicer must still sign the budget document and return a copy to the borrower no later than the end of the first month of the project's fiscal year.

### C. Budget Rejection

If the Loan Servicer rejects the proposed budget because it is found to be unacceptable (for reasons related to outstanding monitoring findings, cost reasonableness, reserves, or the rent increase), the borrower has an opportunity to address the deficiencies.



- The Loan Servicer must return the proposed budget to the borrower with a letter listing deficiencies.
- The borrower has 10 days to submit new information to the Agency. The borrower may adjust the size of the rent increase requested or provide new documentation to justify budget items.
- The Loan Servicer must review the new submissions within 20 days of receipt and either approve or deny the budget.
- If the budget is approved based on the new submissions, the Loan Servicer must sign the budget and send a copy to the borrower.
- If the budget is denied, the Loan Servicer must send the borrower a letter stating the deficiencies and informing the borrower that the previous year's budget remains in effect. The borrower must be given the option to submit a new budget using the previous year's rent levels but adjusted for projected capital expenditures and other known changes for the coming year. The borrower may appeal the budget rejection in accordance with Agency appeal procedures.

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## SECTION 5: REPORTING AND FINANCIAL EXAMINATIONS

### 4.32 MONTHLY AND QUARTERLY REPORTS [7 *CFR* 3560.307]

#### A. Overview of Reports

Financial reporting provides the Agency and the borrower a means to monitor the project's financial progress.

- **Quarterly Reports.** Quarterly reports are required in the following situations:
  - ◇ At completion of new construction or substantial rehabilitation;
  - ◇ When the project is subject to a work-out agreement; and
  - ◇ In the case of reamortization, transfer of an existing project loan, project consolidations, or substitution of general partners.
- **Monthly Reports.** Loan Servicers may require borrowers to prepare and submit these reports on a monthly basis when additional tracking and supervision are needed. (For example, when a project is subject to a work-out agreement or when there has been a violation of program rules or reporting requirements, or the project shows signs of financial distress.)

Loan Servicers may discontinue the reporting requirement for projects that have demonstrated consistent compliance with program requirements over a sufficient time period. (Generally 12 months of consistent compliance is considered sufficient to discontinue the reporting requirements.)

#### B. Review of Monthly and Quarterly Reports

The borrower must submit the required reports to the Agency at the end of each period (quarter or month, as appropriate). Upon receipt, the Loan Servicer must review these reports for the following:

- Look for red flags such as dramatic changes in income, expenses, the general operating account, or the reserve account.
- Check balances on accounts as discussed in paragraph 4.4, to make sure that they are consistent with the management plan, loan agreement/resolution, and the budget.
- Check project expenditures against the budget. Make sure that the project is being operated in accordance with the approved budget.
- Check progress against work-out agreements. Make sure that the borrower is taking any actions indicated in a work-out agreement and is abiding by the established schedule for these actions.

### 4.33 ANNUAL FINANCIAL STATEMENTS [7 CFR 3560.308]

#### A. Overview of Requirements for Annual Financial Statements

To ensure that the project is in sound financial condition and is complying with the program financial management requirements, the Agency requires annual financial statements to be submitted by each borrower. These requirements differ by the type of project.

##### 1. *Requirements for Large Projects*

Large projects, defined as projects with 16 or more units, must submit a GAGAS audit prepared by an independent CPA. The audit guide provides specific instructions on how the auditor should handle compliance issues.

- The audit must be completed using “agreed upon procedures” that help meet the performance standards described in Exhibit 4-6. It must be initiated by the borrower using an engagement letter, which will either:
  - ◊ Reference the Audit guide, which will specify the program compliance issues that the Agency wants the CPA to address, and guidelines for testing compliance; or
  - ◊ State the list of compliance issues that the Agency wants the CPA to address.
- The annual financial statements must be prepared by the CPA, based on the results of the audit.
- All submissions must be prepared for ultimate use by the Agency.

##### 2. *Requirements for Small Projects*

Small projects, defined as projects with fewer than 16 units, must submit annual financial statements that are prepared in a manner consistent with the agency’s audit guide and that is accompanied by a certification signed by the borrower. Note: Borrowers may obtain and submit audits for these properties, and the costs would be an allowable project expense; borrowers must self-certify that the project meets the performance standards described in Exhibit 4-6.

- The annual financial statements may be prepared by a CPA or another individual with the training and experience to prepare the report.
- The information presented in the annual financial statements must be prepared in a manner consistent with the requirements of the audit guide.
- Nonprofit institutions are permitted to have the annual financial statements prepared by a committee of the membership as long as this committee does not include an officer, director, or employee of the borrower.

### 3. *Projects with Common Management*

If projects are managed by a common management entity, operate under the same accounting system and procedures, and have a common managing general partner, the Loan Servicer may allow the borrower to submit annual financial statements for a sample of projects. The annual financial statements must meet the requirements described for large projects.

For the projects not included in the sample, the borrower must submit annual financial statements that meet the requirements for small projects. However, every project must submit a full financial report (as required for large projects) at least every three years.

#### **Exhibit 4-6**

##### **Performance Standards**

The auditor must ensure that:

- Required accounts are properly maintained and tracked separately.
- Payments from operating accounts are disclosed and accurately represented.
- Reserve amount is current (i.e., contributions are on schedule and balance accounts for contributions less authorized withdrawals) and there are no encumbrances.
- Tenant security deposit accounts are fully funded and are maintained in separate accounts.
- Payment of owner return was consistent with the terms of the applicable loan or grant agreement or loan resolution.
- Borrower/grantee has maintained proper insurance in accordance with the requirements of 7 CFR 3560.105.
- All financial records are adequate and suitable for examination.

#### **4. *Other Requirements***

- **Requirements for nonprofit and public bodies.** Nonprofit and public borrower entities must submit annual financial statements in accordance with the requirements established by OMB.
- **Additional Opinions.** The Agency may require additional opinions of financial condition and compliance, such as annual financial statements, to assure the security of the asset, determine whether the project is being operated at a reasonable cost, or to detect fraud, waste, or abuse.
- **Annual Financial Reports.** Any project annual financial statements independently obtained by the borrower must be submitted to the Agency for review.

#### **B. Agency Review of Annual Financial Reports**

Loan Servicers must review financial statements—in accordance with guidelines provided in Exhibit 4-7—to ensure that they meet Agency requirements. In particular, Loan Servicers must:

- Confirm that the audit was conducted by a qualified person as described in the requirements above.
- Confirm that nonprofit and public bodies have submitted the OMB-required annual financial statements.
- Note any problems identified in the examination and determine appropriate corrective actions.

Loan Servicers should use the Annual Agency Review of the Audit/Engagement results to guide their review of the examination results.

**Exhibit 4-7****Agency Review of Annual Financial Statements**

1. **Analysis of actual income and expenses.** Using the actual budget submitted, record the actual income and expenses and note any unexpected variance. In doing so, address the following questions.
  - Did the expenses in any of the four main categories (maintenance and operations, utilities, administrative, and taxes and insurance) differ by more than 10 percent from their proposed levels?
  - Did the actual sources of income (rental, subsidy, and nonrental) differ by more than 10 percent from their proposed levels?
  - Was the vacancy allowance in the permissible range?
  - Were debt payments and reserve payment correct?
  - Was nonoperational cash use reasonable (as compared to last year's)?
  - Was the cash flow positive?
2. **Account maintenance, tracking, and disclosure.** Record the account balances from the report and confirm that the financial report states that:
  - Required accounts are maintained and tracked separately; and
  - Payments from operating accounts are disclosed and accurately represented.
3. **Reserve account status.** From the financial report, record the amounts listed for the reserve balance, deposits, and withdrawals, and confirm that the financial report states that the reserve account is current and that there are no encumbrances on the reserve account funds.
4. **Tenant security deposit account status.** Record the tenant security account balance from the financial report and confirm that the report shows that the tenant security deposit balance meets liabilities and that the funds are maintained in a separate account and in accordance with state law.
5. **Payment of return to owner.** Confirm that the financial report states that the payment of the owner's return was consistent with the terms of the loan agreement or resolution. Record the actual return paid and its effect on cash flow, using the actual project budget.
6. **Insurance status.** Confirm that the financial report states that all relevant insurance requirements were met.
7. **Taxes and other assessments.** Confirm that the financial report states that taxes and other assessments are current. List any taxes or assessments that are not current.
8. **Issues of financial compliance and conditions.** Confirm in the financial report that any funds used for unauthorized purposes have been repaid.
9. **Payment of management fees.** Using the actuals in the financial report, confirm that the management fee was paid in accordance with the management agreement and that the management agent is not charging the project for agent expenses.

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## **ATTACHMENT 4-A**

### **ELIGIBLE PROJECT EXPENSES**

There are generally accepted project expenses that should be charged to the operating account. Some of these expenses are listed below:

1. Actual direct personnel costs of permanent and part-time staff assigned solely to the project site. This includes Managers, Maintenance staff, and temporary help for both types of positions and can cover the following specific items:
  - a. Gross Salary
  - b. Employer FICA Contribution
  - c. Federal Unemployment Tax
  - d. State Unemployment Tax
  - e. Workers Compensation Insurance
  - f. Health Insurance Premiums
  - g. Cost of Fidelity or comparable insurance
  - h. Leasing, performance incentive, or annual bonuses
  - i. Direct costs of travel to off-site locations by on-site staff for property business or training
  - j. Retirement benefits
2. Legal fees directly related to the operation and management of the Property including tenant lease enforcement actions, property tax appeals and suits, all legal documents, and other project relevant matters.
3. All outside accounting fees, if required by RHS, directly related to the preparation of the annual financial report, partnership tax returns and K-1s as well as other outside reports and year-end reports to RHS, HUD, FHA, or other governmental agency. (Preparation of income tax returns for project owners is not an acceptable expense.)
4. All repair and maintenance costs for the project including:
  - a. Maintenance staffing costs and related expenses
  - b. Maintenance supplies
  - c. Contract repairs to the projects (heating and air conditioning, painting, roofing, etc.)
  - d. Make-ready expenses including painting and repairs, flooring replacement and appliance replacement as well as drapery/mini-blind replacement (turnover maintenance)
  - e. Preventive maintenance expenses including repairs and maintenance of occupied units as well as repairs and maintenance of common area systems
  - f. Costs of snow removal
  - g. Costs of elevator repairs and maintenance contracts
  - h. Costs of 504 compliance
  - i. Costs of landscaping maintenance, replacements, and seasonal plantings
  - j. Costs of pest control services
  - k. Other related maintenance expenses

5. Specific costs that must be charged to the Property are as follows:

- a. The costs of credit reports, police reports, and other checks related to tenant selection criteria for prospective residents
- b. The costs of duplicating forms for those properties not owning a copier; this will include the costs of producing or purchasing forms and mailing or delivering those forms to the project site
- c. All bank charges related to the Property, including purchases of supplies (stamps, checks, deposit slips, returned check fees, service fees, etc.)
- d. Costs of site-based telephone, including initial installation, basic services, directory listings, and long distances charges
- e. All advertising costs related specifically to the operations of that project; this can include advertising for applicants or employees in newspapers, newsletters, radio, cable TV, and telephone books
- f. Postage and delivery costs from the site including expenses in mailing the material to RHS, HUD or other governmental agencies, tenants, verifying third parties, central management offices, etc.
- g. Partnership filing expenses including state taxes and other mandated state or local fees as well as other relevant expenses; costs of continuation financing statements and site license and permit costs
- h. Expenses related to site utilities, including actual costs and surcharges as well as deposits and expense of utility bonds in lieu of bonds
- i. Expenses related to industry interface and communications with main office; site office furniture and equipment, including site-based computer and copiers, are included; service agreements and warranties for copiers, telephone systems, and computers are also included (if approved by the Agency—see Chapter 3, Automated Systems, of the Project Servicing Handbook for a discussion of automated systems and industry interface)
- j. Real estate taxes (personal/tangible property and real property taxes) and expenses related to controlling or reducing taxes
- k. All costs of insurance, including property liability and casualty as well as fidelity or crime and dishonesty coverage for on-site employees and the general partners
- l. Costs of collecting rents on-site including bookkeeping supplies and record keeping items
- m. Costs of preparing and maintaining tenant files and processing tenant certifications including all office supplies, copies, and other associated expenses
- n. Public relations expenses relative to maintaining positive relationships between the local community and the tenants, and the management staff and the owners; Chamber of Commerce duties, contributions to local charity events, sponsorship of tenant activities, etc., are examples of such expenses
- o. Tax Credit Compliance Monitoring Fees imposed by HFAs (a controversial item)
- p. All insurance deductibles as well as adjuster expenses
- q. Professional service contracts (audits and compilations, tax returns, energy audits, utility allowances, architectural, construction, rehabilitation and inspection contracts, etc.)
- r. On-site training, preapproved by RHS
- s. Site manager salary for additional hours associated with congregate housing
- t. Service coordinators for elderly and congregate housing
- u. Offset taxes on serve income (phantom income)

**ATTACHMENT 4-B**

***FORM RD 1930-7, MULTI-FAMILY HOUSING PROJECT BUDGET***